STATE OF CALIFORNIA

PETE WILSON, *Governor*

PUBLIC UTILITIES COMMISSION
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October 18, 1994

VIA FEDERAL EXPRESS

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20036

Re: PR Docket No. 94-105

Dear Mr. Caton:

Please find enclosed for filing an original plus eleven copies of the following:

1. REPLY BY CALIFORNIA TO OPPOSITIONS TO CPUC PETITION TO RETAIN REGULATORY AUTHORITY OVER INTRASTATE CELLULAR SERVICE RATES

2. APPENDICIES TO REPLY BY CALIFORNIA TO OPPOSITIONS TO CPUC PETITION TO RETAIN REGULATORY AUTHORITY OVER INTRASTATE CELLULAR SERVICE RATES

3. Certificate of Service

Also enclosed is an additional copy of these documents. Please file-stamp these copies and return them to me in the enclosed, self-addressed, postage pre-paid envelope.

Very truly yours,

Ellen S. LeVine
Principal Counsel

ESL:dbn

Enclosure (13)

No. of Copies rec'd 0+11
List A B C D E

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Petition of the People of the State of California and the Public Utilities Commission of the State of California to Retain Regulatory Authority over Intrastate Cellular Service Rates	)	PR Docket No. 94-105

REPLY BY CALIFORNIA TO OPPOSITIONS TO CPUC PETITION TO RETAIN REGULATORY AUTHORITY OVER INTRASTATE CELLULAR SERVICE RATES

October 18, 1994

TABLE OF CONTENTS

SUMMARY

In our petition, the People of the State of California and the Public Utilities Commission of the State of California ("CPUC") demonstrated with substantial evidence that market conditions within California cellular markets are not yet adequately competitive in order to ensure just and reasonable rates for cellular services to California's residential and business consumers. The CPUC showed that, currently and for the near future, significant legal, technical and economic barriers to entry preclude effective competition with the incumbent duopoly cellular carriers. The CPUC further showed that neither personal communications services nor enhanced specialized mobile radio services -- the services likely to be close substitutes for cellular service -- are currently operational.

In addition, in analyzing the market share and market concentration ratios for the duopoly cellular carriers in accordance with guidelines adopted by the Department of Justice and relied upon by the Federal Communications Commission, the CPUC found strong evidence of market power by such carriers. That finding was further substantiated by earnings data of duopoly carriers operating in major California markets, which indicated that such carriers were realizing returns well in excess of those expected in effectively competitive markets.

Moreover, in examining pricing data for cellular services, the CPUC found that prices had not substantially declined commensurate with what one would expect in effectively competitive markets. Evidence of parallel pricing behavior and

interlocking ownership alliances between carriers provided further support that cellular markets are not effectively competitive.

The accumulation of all this evidence leads to the inescapable conclusion that the markets for cellular services in California are simply not yet sufficiently competitive to ensure just and reasonable rates for California's consumers of cellular services. Accordingly, the CPUC seeks to retain its regulatory oversight of cellular service rates for an eighteen month period, beginning September 1, 1994, after which the CPUC expects that new services will provide consumers with competitive alternatives to existing cellular services offered by the duopoly carriers.

Predictably, the duopoly carriers attempt to explain away all of the evidence presented by the CPUC. However, they do so by misstating applicable law, misstating the facts, omitting pertinent data, and distorting the CPUC's market analysis. They also concoct new theories and economic guidelines or misapply existing guidelines in an attempt to rebut the CPUC's reliance on commonly-used standard economic theory. In addition, they offer their own studies, but all of these, designed to produce a preconceived result, are fraught with serious and fundamental errors.

Further, their characterization of CPUC regulation bears no resemblance to reality, as the CPUC decisions in their entirety (not selectively excerpted) make clear. Their characterization does, however, graphically illustrate the duopoly carriers' resistance to any form of regulation.

Finally, the carriers raise numerous procedural roadblocks, all in an attempt to divert attention from the strong evidence proffered by the CPUC which is damaging to their cause and that they are unable to refute. Indeed, they even try to have this evidence excluded altogether.

In the end, when all of the carriers' hyperbole is dismissed, they cannot escape the fact that the CPUC has met the standard set forth by Congress in the Budget Act amendments that market conditions in California are not yet sufficiently competitive to ensure just and reasonable rates for California consumers of cellular services. Having met that standard, the CPUC respectfully urges the FCC to grant its petition.

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REPLY BY CALIFORNIA TO OPPOSITIONS TO CPUC PETITION TO RETAIN REGULATORY AUTHORITY OVER INTRASTATE CELLULAR SERVICE RATES

The People of the State of California and the Public Utilities Commission of the State of California ("CPUC") hereby reply to the oppositions filed against the CPUC's Petition to Retain State Regulatory Authority Over Intrastate Cellular Service Rates in the above-referenced matter. None of these oppositions undercut the CPUC's findings that cellular service markets in California are not yet sufficiently competitive to ensure just and reasonable rates for California business and residential consumers.

Predictably, nearly all opposition to the CPUC petition is from the incumbent duopoly cellular carriers who have steadfastly resisted all efforts by the CPUC to exercise regulatory oversight of the charges for cellular service and efforts by both the CPUC and California State Legislature to foster additional competition by other entrants into the cellular markets. Their oppositions in turn are riddled with serious misstatements of fact, material omissions of pertinent data, and major distortions of the CPUC's market analysis. And when the carriers cannot refute the CPUC's analysis, they invent their own, concocting standards, theories and methodologies unique to this proceeding to achieve their desired result.

They further mischaracterize CPUC regulation, both substantively and procedurally, maintaining that the CPUC plans to adopt rate-of-return regulation of the cellular industry. Of course, that is nonsense. And they are simply wrong in claiming that the CPUC petition or CPUC regulation somehow conflicts, or is not in compliance, with federal or state law.

Finally, and incredibly, they claim that much of the data which the CPUC submitted in support of its petition cannot be disclosed under any terms and conditions, notwithstanding its relevancy and materiality to the CPUC petition; hence they claim the CPUC petition must be rejected out of hand for failure by the CPUC to sustain its burden of proof.[1] A greater violation of the CPUC's due process rights can hardly be imagined.

In the end, when all is said and done, the cellular carriers cannot refute, and in fact are compelled to admit that:

- There are currently and for the near future significant barriers to entry into the duopoly cellular markets which preclude effective competition for

1. At the same time, the Cellular Telephone Industry Association ("CTIA") relies on data that it claims must remain confidential but nevertheless should be considered by the FCC. The industry cannot have it both ways.

cellular services. At the same time, there is substantial evidence that the duopoly cellular carriers in each market are not effectively competing with each other;

- New competitive services, such as Personal Communications Service ("PCS") and Enhanced Specialized Mobile Radio ("ESMR") service, which are close substitutes for cellular service, are not currently available in California, and hence, are not yet effective competitors to cellular service;

- Current and historical market share data and market concentration ratios for the duopoly cellular carriers strongly evidence market power by cellular carriers in California markets;

- Earnings data, relied upon by regulators and the investment community, indicate that the duopoly cellular carriers are realizing returns well in excess of returns expected in effectively competitive industries;

- Prices for cellular services in California have not substantially declined commensurate with what would be expected in effectively competitive markets; and

- Capacity utilization rates do not explain cellular price levels.

In sum, the duopoly carriers have failed to contradict the findings of the CPUC that California cellular markets are not yet adequately competitive to ensure just and reasonable cellular rates to California business and residential consumers. Accordingly, state regulatory oversight of the charges for cellular service must be retained until sufficient competition emerges in intrastate markets.

I. **THE CPUC ADOPTED A PROPER ANALYTIC FRAMEWORK IN CONCLUDING THAT CELLULAR MARKETS IN CALIFORNIA ARE NOT CURRENTLY COMPETITIVE**

In their scorched earth approach, the cellular carriers begin by attacking the analytic framework under which the CPUC has performed its study of intrastate cellular markets. They complain that the CPUC applied the wrong statutory standard, the wrong federal guidelines for determining competitiveness of markets, and the wrong criteria and factors in accordance with such guidelines. The CPUC did none of this. To the contrary, it is the duopoly cellular carriers who attempt to define a new standard, attempt to ignore federal guidelines, and attempt to overlook evidence damaging to their position -- all in an effort to skirt the CPUC's substantial showing that competitive forces in California markets are simply not yet adequate to ensure just and reasonable charges for cellular service. Their approach must fail.

A. The CPUC Has Applied the Statutory Standard Expressly Set Forth in the Budget Act

Section 332(c)(3) of the Omnibus Budget Reconciliation Act ("Budget Act")[2] sets forth clearly the standard that a state must meet in retaining regulatory oversight of intrastate cellular service charges. Section 332(c)(3(i) provides that the

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2. Omnibus Budget Reconciliation Act of 1993, amending Communications Act of 1934.

FCC must grant a state petition to retain such oversight if the state demonstrates that:

> (i) market conditions with respect to such services fail to protect subscribers adequately from unjust or unreasonable rates or rates that are unjust or unreasonably discriminatory.

The CPUC has met that standard.[3] The carriers thus attempt to redefine it in a manner virtually impossible for anyone to meet. For example, many claim that states must show market conditions are "substantially less competitive and substantially more likely to cause harm to consumers" than the interstate market conditions relied upon by the FCC in deciding to forbear from interstate rate regulation.[4] They then claim that the state must explain why federal remedies are inadequate to protect local cellular ratepayers from unjust and unreasonable intrastate charges.[5] Finally, for good measure, they say that a state must "show any residual risks to consumers. i.e., the marginal benefits of the proposed state regulation, outweigh the substantial costs associated with regulation."[6]

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3. Section 332(c)(3)(ii) sets forth an alternate test which the CPUC has not invoked here. Los Angeles Cellular Telephone Company ("LACTC") thus completely misapprehends the CPUC petition. LACTC at 2.

4. McCaw at 6.

5. Id. at 7.

6. Id.

Others assert that the CPUC must demonstrate that cellular carriers have violated federal antitrust laws in order for the CPUC to meet its burden. Among other things, they claim that the CPUC must show collusion or price fixing between the duopolists in a given market.

The revised statutory standard advocated by the carriers bears no resemblance to the one adopted by Congress. First, the degree of competitiveness of the interstate market is irrelevant to whether particular markets within a state are competitive. To be sure, Congress carved out a role for the states because Congress understood that competitive conditions in discrete intrastate markets may well differ from those in interstate markets. Accordingly, as the carriers themselves recognize, Congress left it to each state to evaluate market conditions "unique to that state" and to ascertain whether such conditions will ensure just and reasonable charges for cellular service.[7]

Second, where a state has found that market conditions are inadequate to ensure just and reasonable charges for intrastate cellular service, Congress did not intend that a state seek federal relief on behalf of its local ratepayers. To the contrary, Congress intended for a state to exercise its own regulatory oversight to ensure just and reasonable rates for intrastate consumers of cellular service. The area carved out for the states under the Budget Act amendments to the Communications Act is thus fully consistent with the dual

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7. McCaw at 6.

regulatory scheme which continues to underlie the Communications Act.

Further, the claim that states must show how the allegedly unquantified "substantial costs" of regulation outweigh its "marginal benefits" to consumers is baseless, and serves only to highlight the carriers' antipathy to any state regulation of their industry.[8]

Finally, had Congress intended to adopt an antitrust standard in the Budget Act, it would have said so. It did not, and properly left such enforcement of the antitrust laws to the United States Department of Justice ("DOJ").

In sum, as the FCC itself said, "Section 332(c)(3) is clear as to the circumstances under which the states may be permitted to petition the Commission for authority to regulate rates for CMRS and the criteria upon which they must base their petitions." In the Matter of Implementation of Section 3(a) and 332 of the Communications Act, Regulatory Treatment of Mobile Services, <u>Second Report and Order</u>, 9 FCC Rcd 1411, 1504, ¶250. Accordingly, just as the FCC, in implementing the Budget Act, implicitly rejected a revised standard pressed by the carriers,

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8. <u>See</u>, <u>e.g.</u>, AirTouch at 61 and 71 ("CPUC...does not have the vision to create a progressive framework for competition as required by Congress" and "simply does not have the skill or perspective to regulate this market consistent with the federal plan.")

At the same time, AirTouch never mentions that it was one of the cellular carriers instrumental in defeating 1994 state legislation supported by the CPUC which would have substantially relaxed regulatory requirements for wireless competitors.

so the FCC must reject the carriers' attempt to resurrect such a standard here. Id. at 1502, ¶243.

B. The CPUC Properly Relied On Department of Justice Guidelines In Finding that Intrastate Cellular Markets Are Not Competitive

Not only has the CPUC applied the proper statutory standard in analyzing intrastate cellular markets, but the CPUC has also properly relied on guidelines adopted by the United States Department of Justice ("Merger Guidelines") in analyzing the competitiveness of these markets. The April 2, 1992 revision of the Merger Guidelines, which was issued jointly with the Federal Trade Commission ("FTC"), affirms the appropriateness of methodology the CPUC used in its analysis of the competitiveness of the cellular industry. Like the CPUC, the DOJ and the FTC consider product substitutability, potential for price discrimination, geographic boundaries of markets, number of competitors, market share (measured in dollars per unit of output), and market concentration (measured with the Herdfindahl-Hirschman Index).[9]

This methodology is commonly used in assessing markets. The FCC recognized the usefulness of the Merger Guidelines for assessing the extent of competition in CMRS markets.[10] The FTC

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9. U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, April 2, 1992 at 10-25.

10. In the Matter of Implementation of Sections 3(n) and 332 of the Communications Act, Regulatory Treatment of Mobile Services, Third Report and Order, slip op. at 27.

has applied this methodology in previous testimony before the FCC on the cellular industry. For example, in the FCC's CC Docket No. 91-34, regarding bundling of cellular customer premises equipment and cellular service, the FTC used the DOJ Merger Guidelines in assessing the competitiveness of the cellular service industry.[11] The CPUC notes that the FTC found that the cellular service industry is not competitive. In addition, the Cellular Resellers Association ("CRA") and Owen on behalf of McCaw also follow the Merger Guidelines to define a relevant product market.

In short, the CPUC appropriately relied upon and applied the Merger Guidelines in finding that cellular markets in California are not currently competitive. It is only the cellular carriers who seek to abandon those guidelines here. Their efforts must be rejected.[12]

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11. Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, July 31, 1991, p. 9, In The Matter of Bundling of Cellular Customer Premises Equipment and Cellular Service. See App. B.

12. In a similar vein, McCaw criticizes the CPUC for assessing the cumulative impact of the factors used to evaluate the state of competition in intrastate markets in accordance with the DOJ guidelines. The criticism suggests that one factor may suffice to demonstrate the non-competitiveness of markets -- a position that no regulator, either state or federal, has deemed appropriate.

C. The CPUC Properly Evaluated All Relevant and Material Factors In Establishing the Non-Competitiveness of Intrastate Cellular Markets

In its Second Report and Order, the FCC suggested the types of evidence and information that, as a general matter, it would consider in evaluating state petitions. The FCC made clear that the list was "non-exhaustive" and simply "examples" of information that might be considered by the FCC. Second Report and Order, 9 FCC Rcd at 1521, Section 20.13(a)(2). The FCC in fact stated that "a state should have discretion to submit whatever evidence the state believes is persuasive." Id. at 1504, ¶252.

Several carriers once again distort federal intent and attempt to defeat the CPUC petition by converting a list of exemplary factors to one of mandatory factors. Others claim that the CPUC considered little or no evidence regarding these factors, while simultaneously attempting to refute the very evidence they say does not exist.[13] The carriers themselves cannot agree on what to argue.

In sum, other than to divert attention from the substantial evidence presented by the CPUC which is damaging to their cause, none of these arguments have any merit. The CPUC properly evaluated all relevant factors in establishing the lack of effective competition in California cellular markets.

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13. Compare AirTouch at 11 n.25 with AirTouch at 12.

II. THE CPUC HAS PRESENTED SUBSTANTIAL EVIDENCE WHICH SATISFIES THE STATUTORY STANDARD THAT MARKET CONDITIONS WITHIN CALIFORNIA ARE NOT YET ADEQUATELY COMPETITIVE TO ENSURE JUST AND REASONABLE CHARGES FOR INTRASTATE CELLULAR SERVICES

A. The CPUC Has Properly Defined The Relevant Market by Delineating Viable Substitutes For Cellular Services

As the CPUC stated in its petition, a substitute for cellular services must possess the following characteristics:

> (1) Be offered to individual members of the public, i.e., it must be available to individuals, not just fleets, upon request;
> (2) Be integrated into the public switched telephone network;
> (3) Provide similar quality two-way voice communication;
> (4) Have sufficient signal to serve at least two-thirds of the population of its service area and must be available in all service areas in California;
> (5) Be portable;
> (6) Be mobile; i.e., consumers can use at driving speeds;
> (7) Provide roaming i.e., it is useable outside the customer's serving area.

Petition at 64-65. Based on our analysis, the CPUC concluded that there are currently no substitutes for cellular service in the wireless market, but that we expect ESMR and PCS to emerge as substitutes. The short 18 month duration of our request for extended regulatory authority is based on the expectation that substitutes will stimulate competition in the wireless market during this period.

The carriers claim that the CPUC did not take sufficient account of substitutes to cellular service because the petition: (1) provided too narrow a definition of substitutes;

(2) did not recognize the existence of current substitutes, namely NEXTEL; and (3) did not recognize the potential for substitutes in the future. The carriers are mistaken on all counts.

1. The CPUC Provided a Reasonable Definition of Substitutes for Cellular Service

While many carriers disagree with the way the CPUC defined substitutes for cellular services, in fact the resulting identification of ESMR and broadband PCS as likely substitutes for cellular in a larger mobile wireless market is substantially similar to theirs. The primary substantive difference between the CPUC and the duopoly carriers is over timing: The CPUC does not consider a mobile wireless service a viable substitute until the service can be acquired by consumers. We also differ over method and the treatment of pagers and payphones.

Our view of considering substitutes only when they have features we have identified has a distinct advantage: it removes the discussion from the abstract to the concrete. The duopoly carriers sometimes lose sight of the fact that it is necessary for a service to exist and be operational in California before it can be considered a substitute. The primary substitutes, ESMR and PCS, need to have a widely deployed network, and available customer equipment. While spectrum allocation is necessary for the provision of these services, it is not sufficient in and of itself to qualify such services as substitutes.

Our analysis emerged from the FCC's suggestion that states petitioning to retain regulatory authority should identify substitutable services.[14] To identify substitute services, we first defined the features of the service over which we were seeking continued regulatory authority: cellular service. Next, we identified two services, PCS and ESMR, which may satisfy this definition and have the potential to become substitutes. AirTouch in contrast argues that we should have relied on cross elasticity demand. While we agree that using cross elasticity is a sound, factually based method for identifying substitutes, this would be difficult to ascertain empirically, considering that the closest substitutes do not yet exist, are not operational today, and thus are not effective competitive substitutes today.

Several carriers further argue that pagers or payphones should be considered viable substitutes to cellular service. The CPUC and many of the cellular industry's economists do not agree.[15] Many of the carriers' economists approached this question by identifying the relevant product market according to the Merger Guidelines.[16] The Merger Guidelines suggest a test for identifying the relevant product market: if a hypothetical

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14. Second Report and Order, 9 FCC Rcd 1411 at Appendix A, Section 20.

15. Neither pagers nor payphones are currently viable substitutes for cellular service for consumers caught in commute traffic, for consumers in rural areas where payphones may be scarce, or for security-minded consumers who selected cellular service to avoid leaving their cars to use a payphone. As the technologies evolve, they may become closer substitutes.

16. "An Antitrust Analysis of the Market for Mobile Telecommunications Services" prepared for Cellular Telecommunications Industry Association, Charles River Associates, December 8, 1993, p. 16.

monopolist could raise its price by a small but significant amount and increase profits. If substitutes were available, consumers would abandon the monopolist and seek alternatives in such numbers that profits would not increase. If pagers and payphones were substitutes, the hypothetical cellular monopolist would not increase its profits if it were to raise prices by a small amount because it would loose business to these substitutes. Economists for the cellular industry found that under certain conditions cellular, ESMR and PCS could be considered part of the same market.[17] Owen, on behalf of McCaw, recognizes that while cellular phones may be part of other markets, such as payphones, pagers, telemetry and intraLATA toll, there is a distinct mobile telecommunications market comprised of cellular, ESMR and PCS of which these other services are not a part.[18]

In short, the CPUC's identification of substitutes to cellular service is reasonable, and endorsed by many of the carriers themselves.

2. The CPUC Recognized the Existence of Current Substitutes for Cellular Service

Contrary to AirTouch's characterization,[19] at no point does the CPUC petition argue or could reasonably be construed to argue

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17. Charles River Associates, 1993, p. 16.

18. McCaw, Exhibit A at 9.

19. AirTouch at 35.

that PCS and ESMR may not be viable substitutes for cellular service. In fact, the CPUC petition presented a much more optimistic view of the prospects for competition from PCS than AirTouch's Senior Executive officers, one of whom has said, "I don't believe PCS will ever catch up to -- let alone surpass -- cellular" and that it will take PCS carriers seven or eight years to deploy networks as ubiquitous as cellular.[20]

3. The CPUC Recognized the Potential for Substitutes for Cellular Service

Notwithstanding the above, some of the carriers distort the CPUC's analysis by claiming that the CPUC did not recognize the potential for new competitive entry.[21] That claim, however, is squarely contradicted in our petition, which clearly recognizes that emerging technologies -- namely, ESMR and PCS -- are likely competitors to cellular in emerging wireless markets.[22]

To be sure, it is the duopoly cellular carriers who distort reality by creating the impression that ESMR services and PCS are currently viable competitors to cellular services within California. With careful draftsmanship, they say that "California already has access to ESMR service," (AirTouch at 33)

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20. "AirTouch Execs Say PCS Will Play Small Role" Telephony, April 18, 1994, p. 12.

21. AirTouch at 33; GTE Mobilenet at 39.

22. Petition at ii, 7, 63, 65, 68, 71-72, 83.

and that "Nextel has been operational in Southern California for some time." [23]

They also use terms such as "commercialization of ESMR" to imply that cellular-like service is offered by Nextel. This is misleading because it obscures the important distinction between ESMR and cellular-like service. The fact is that Nextel does not now provide a single customer with stand-alone, cellular-like service in California, a service which is a close substitute for cellular service. Today, Nextel provides only an enhanced dispatch-type service to 5000 customers in California, with optional cellular service. See Affidavit of Kevin Gavin, attached in App. F. Nextel does not now, and for the near future will not, provide two-way, stand-alone cellular service in competition with the duopoly carriers. While the CPUC is hopeful that Nextel will become a viable competitor to the duopoly carriers in the near future, at this time Nextel has simply "announced plans" to offer such competitive service, and nothing more.[24] Indeed, Nextel's recent setback in losing MCI as a major investor may indicate that ESMR will take time to become a

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23. Id.

24. AirTouch argues that we should not rely on the statement of Nextel's counsel, but instead should rely on Nextel's prospectus. AirTouch at 33 n 90.

viable competitor.[25] Moreover, as the FCC has observed, Nextel's spectrum has some disadvantages because it is shared with other users.[26]

Similarly, some carriers imply that PCS service is currently in place and that "Cox Enterprises, with its Pioneer's Preference and existing infrastructure, is positioned to expedite service."[27] Yet, neither Cox nor any other provider of PCS service is currently providing PCS service in California other than as a test. And even after such providers obtain licenses from the FCC, most in an auction which has not yet been held to confer such licenses, the carriers' executives themselves admit that it will take years before PCS is an effective competitor to cellular service. [28]

In sum, there is no current competition from new entrants into the cellular market in California. [29] The CPUC anticipates that either ESMR or PCS will become effective competitors by eighteen months from September 1, 1994.

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25. While the CPUC believes that Nextel will be able to surmount whatever technical problems may exist, the fact remains that in California, Nextel is not yet serving cellular customers on a stand-alone basis and is not a viable competitor to cellular service. See Appendix C.

26. Second Report and Order, 9 FCC Rcd at n. 296.

27. See e.g., AirTouch at 33.

28. "AirTouch Execs Say PCS Will Play Small Role," Telephony, April 18, 1994, p. 12. See App. C.

29. Even the duopoly carriers themselves couch their arguments regarding the entry of providers of ESMR and PCS in tentative or future terms.